DOW THEORY LETTERS INC.

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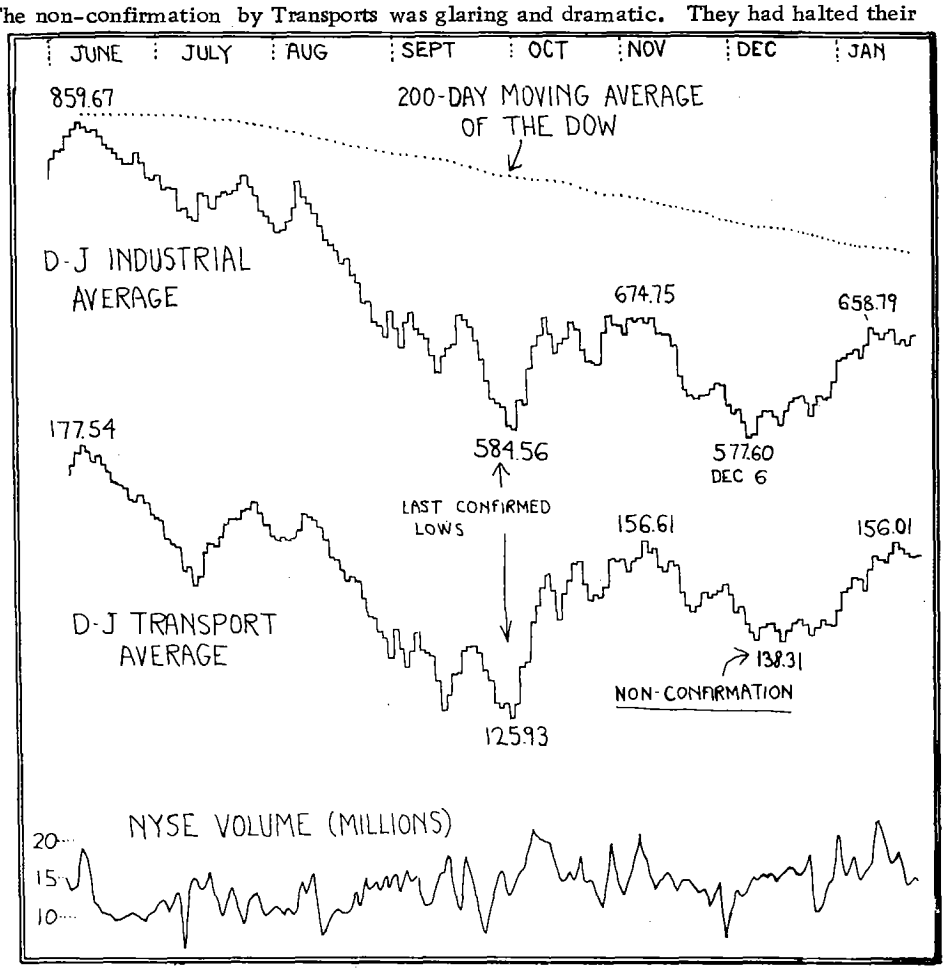
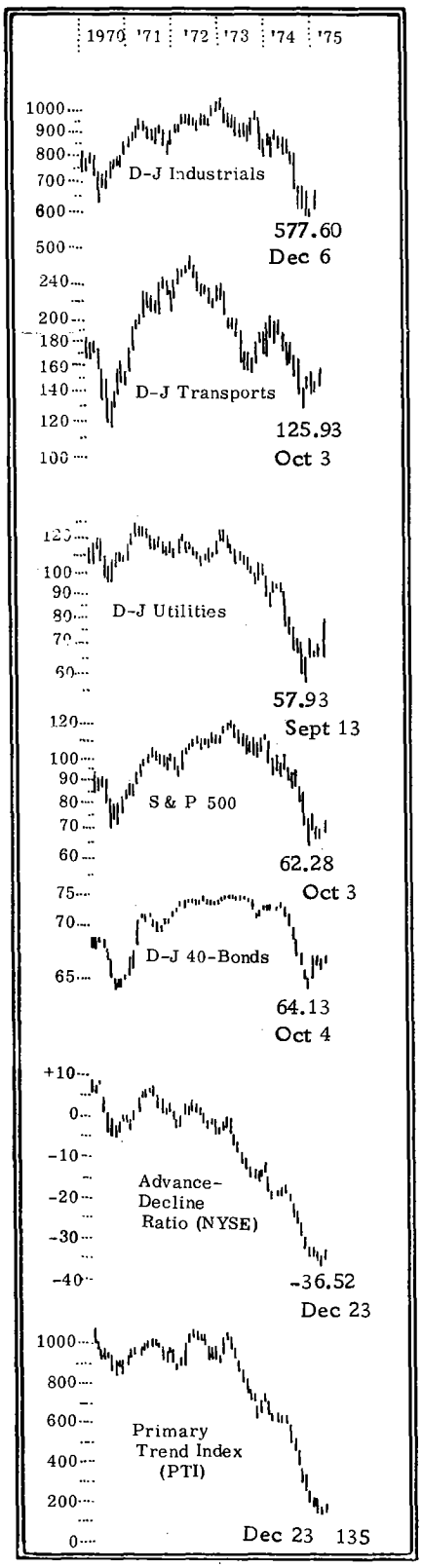
"Man has life and death before him; whichever a man likes better will be given him."
Ecclesiasticus 15:17

Many men are by nature optimists. Others, whether through childhood experience or through the trials of life, have become pessimists. Personally, I feel that man is optimistic by nature. Why else would he go on in the face of the tragedies, stupidities and difficulties that he faces in the world? And why else does man alone, of all the creatures, possess the ability to laugh and smile? But being optimistic (if you are) or pessimistic (if that is your disposition) should not interfere with your stance in the market. The thing we strive for in the market (and hopefully everywhere else) is reality, the truth, the facts. For it is certain that the perpetual bear will be crushed in the first bull market just as it is certain that the perpetual bull will be slaughtered in the first bear market.

THE BILLION DOLLAR QUESTION: The D-J Transportation Average recorded a low of 125.93 on October 3, 1974. One day later the D-J Industrial Average recorded a low of 584.56. Those lows (see chart) were the last joint or confirmed lows of the bear market. At no time since have both Averages been lower. After the October lows, the two Averages advanced into November. At the November peaks the Industrials stood at 674.75, the Transports at 156.61.

From the November highs, a new decline got underway. By December 6 Industrials had closed at a new bear market low of 577.60. On December 16 Transports recorded a low of 138.31. The non-confirmation by Transports was glaring and dramatic. They had halted their





 December decline 13 points above their earlier October low. No Dow Theorist could have ignored that non-confirmation, particularly since it came in the face of dismal economic news and a crescendo of ominous warnings from politicians, economists and market advisories.

Following the December lows, the market turned up again. That advance contains the secret of the primary trend. The question, of course, the single question that occupies every Dow Theorist's mind is — whether the two Averages are ultimately fated to rise above their November highs, or whether they are going to break below their October-December lows.

There is no question about it, the groundwork has now been prepared for a possible change in the primary trend. But ironically at this point there isn't a man on the face of the earth who can say with any certainty or authority, "This is a primary bull market" or "We are still in a primary bear market." Only the Averages can make that statement, thereby answering what is probably the most critical question in the world today.

A continuation of the bear market would be signalled by new primary lows in both Averages, Industrials going below 577.60 and Transports going below 125.93. I sincerely hope that doesn't happen, not because of any trading losses that I or my subscribers might suffer (and such losses would probably be minimal), but because of the tragedy it would spell out for the US and the rest of the world. If the worst that can now be seen ahead does not satisfy the bear, then new lows in the Averages would surely spell depression, massive bankruptcies, credit chaos and perhaps a shaking of the very foundations of Western civilization.

On the other hand, a primary bull signal in the period ahead would at least buy time for the West and, considering the shape we are in, time is certainly needed. Obviously there is no guarantee that our leaders would take any fundamental steps to help us out of the current predicament, but whatever they do, they will need time. So this writer, without mixing hopes and emotions with an unemotional reading of the Averages, would like to see a primary bull signal in the period ahead. Whether we get it, whether the Industrials and Transports will oblige us by rising above their 674.75 and 156.61 points respectively, is another story. That is the story that only Wall Street can tell us. And I for one will listen to and act on "the bloodless verdict of the market."

So we are now in that "no-man's land" between the last primary low points of the bear market and the primary peaks, which, if bettered, would signal a new primary bull market. How long could it take before we know what kind of market (bull or bear) we're in? There is no time limit on Wall Street, none. We could know in a few days or it could take six months. The market will not be hurried in its verdict, and as Mr. Truman once put it, "If you can't stand the heat, stay out of the kitchen."

I will say that it is normal for the market to hesitate, re-consolidate, back off, become nervous, as it approaches primary points, and that is about the way I would describe the action of the past week. Meanwhile, the Boardroom Charlies talk nervously about their "new indicators" or their latest theories on why the market has "got to" do this or that. My advice is that you write all the talk and theories off as so much hogwash. But under the guise of a trendless series of Wall Street sessions, a grim battle is going on between the bulls and the bears. Ultimately, one army will exhaust the other, and we will know where the great power lies. If it lies with the bulls, then the November peaks will be bettered. If the bears still retain control of the markets, then in due time the Averages will plunge below their 1974 lows.

History may or may not help in our reading of the Averages, but it often serves as a guide. What happened at previous bear market bottoms, preparatory to primary bull signals? Here is the modern record of the three major bear market to bull market turns.

In 1932, following the first major rise from July to September, the market backed off. Bettering the September highs (by both Averages) would signal a bull market, following the greatest crash of all times. The signal came in May, eight months after the first peaks.

The 1942 bear market turned up in April, with the Averages recording highs in July of 1943. A reaction occurred, as all eyes riveted on the July peaks. Why, because a new advance and the bettering of those July peaks would signal a primary bull market. In June of 1944 the Averages both passed the July, 1943 peaks. The bull signal came 11 months after the initial highs.

A bear market ended in June, 1949. The market turned up in a major swing that ended on June 12, 1950. A correction followed, and according to Dow Theory a bettering of the June 12 highs would signal a primary bull market. The bull signal came in October, four months after the first major peaks.

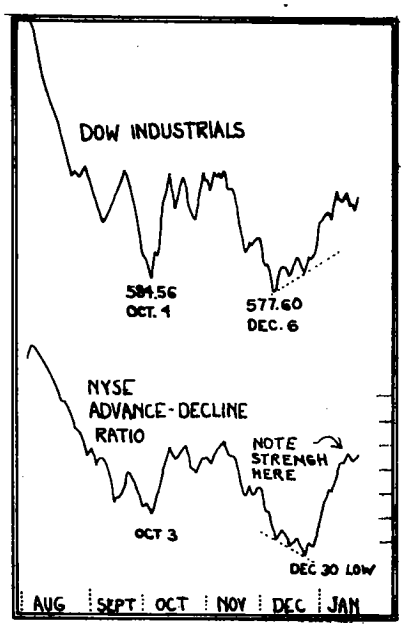
Taking those three primary bull market signals, if we measure the average time elapsed between the first peaks in the new bull market and the point at which those first peaks were bettered (or the point of the primary bull signal), we get an average of 7.6 months.

How does this translate into the present situation? Let us assume that a bull market started on October 3, 1974. Then the first advance carried to November 5, 1974. If we take the average of the time elapsed for confirmation, using the three preceding bull markets as our model, we might expect the Industrials and Transports both to better their November peaks (7.6 months later) around early June, 1975. That would signal a new primary bull market.

In other words, following the first primary bull swing in a new (but unconfirmed) bull market, it takes time, numerous scares, backing and filling, many false starts, before we can expect a confirmation. To put it another way, if the Averages better their November peaks during February or before, it would be the fastest bull market confirmation of any in modern history. Conclusion: Take it easy, don't load up (we could still be in a bear market correction), hold your trading commitments to 33% (or down to 15% for nervous readers), don't get in a stew, exercise patience, much patience.

Question: Russell, stop all the statistical and philosophical nonsense and put yourself on the line and earn your money. Do you or do you not think we are in a bull market? Answer: All right, you want my guess (which may be no better than your barber's guess)?

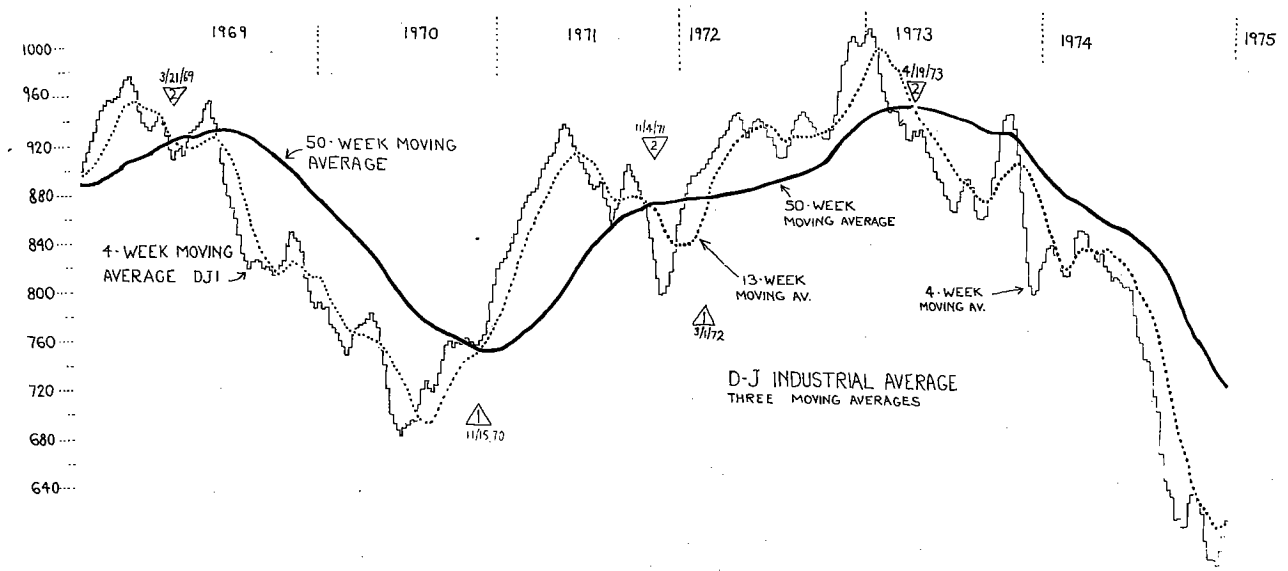
W e l l, I would guess we are in a bull market. I say this because according to strict Dow Theory a reconfirmation of the bear market would entail new lows by both Averages, Industrials under 577. 60, Transports below 125. 93. I base my answer part on intuition, part on the extraordinary action of the Transports. The Transports (without any help from the Airlines, so far) do not act to me as if they want to go down very far. They just don't. Of course it could happen, but I would be amazed to see Transports go under 125. 93, down another 25 points from here. This market could "mess around," absorb a lot of bad news, scare hell out of everybody, but I would be surprised to see both Averages at new lows.



Short-Term: There is nothing more deceptive than the action of the market or the Averages in that hazy territory between primary points. Nevertheless, for day-to-day trackers, the ability of Transports to hold above their January 8 closing low of 146. 63 will be worth watching. On Industrials, the ability to hold above the halfway level of the December-January advance will be a hopeful sign, and the halfway level is 618. 19. Below that, the nearest point of any significance is the 589. 64 low of December 23, then the bear market low of 577. 60.

The "breadth stampede" discussed in the last Letter is still in effect despite the "overbought" condition of the market and the reactionary tendencies that began on January 17. The accompanying chart shows that the A-D ratio has, so far, failed to drop as much as a point and, as long as this holds true, I will consider the initial phase of the stampede as intact (scale at right of chart shows one-point division for A-D ratio). It is well to remember that very strong markets often move sideways and reconsolidate in lieu of correcting to lower levels.

MOVING AVERAGES: In Letter 617 I presented my study of the Dow momentum, and I discussed the value of momentum ratios in identifying important turns in the market. (The S & P 425 momentum is discussed in this report). A second study that I have found of great value is the one that deals with the moving averages (MA's of the Dow). A discussion of the three MA's appeared last in Letter 612.



For the purposes of this study, I use three MA's of the Dow, a 4-week or short-term MA, a 13-week or medium-term MA and a 50-week or long-term MA. Crossing of the three MA's provide the various signals. A crossing of the 4-week MA above or below the 13-week MA is considered an "alert" signal. These may occur fairly frequently and I do not accord them major importance. Since alert signals always precede major signals, I do consider an alert signal as potentially important. For this reason I note them carefully when they occur, but I do not act on them.

Next, the major signals: When the 13-week MA crosses above the 50-week MA we have a major bull signal (labeled #1 on the chart). Conversely, when the 13-week MA drops below the 50-week MA we have a major bear signal (#2). Note that these major signals do not occur very often. Since 1969, as seen on the chart, there have been only five such signals. It is also worth noting that the greatest part of any major bull market advance occurs after a #1 bull signal. By the same token, the largest part of bear market decline occurs after a #2 bear signal by the MA's.

To put it another way, if one confined himself only to buying upon bull signals in the MA's and to selling only after bear signals in the MA's, he would be on the right side of the market most (not all, but most) of the time. These signals by their construction cannot

catch the absolute bottom or the ultimate top, but then it is said that the man who buys at the exact bottom and sells at the exact top is either a gambler or a liar.

I should also say that I give most credence to the major bull and bear signals in the MA's when they occur in the direction of the primary trend.

In other words, in 1973 we received a major bear signal (April 19), and I considered this signal of prime importance. The 13-week MA broke below the 50-week MA on that date (the Dow closed at 962.20 on April 19), and in the ensuing 20 months the Dow fell almost 400 points. I'd call that sell signal a good example of keeping us "on the right side of the market."

During the latter part of 1974 we were engulfed in what I considered to be the third phase of the primary bear market. The 13-week MA has been under the 50-week MA for almost two years. During the weeks of December 5 and 12 the distance between the 13-week and 50-week MA's had spread to 133 points, the greatest downside spread in these two MA's since this bear market began in 1966. In the week of December 26 the distance shortened to 131 points, and by January 17, the distance had contracted to 114 points. This could be the beginning of the trend that will bring about a bullish crossing (with the 13-week MA above the 50-week MA).

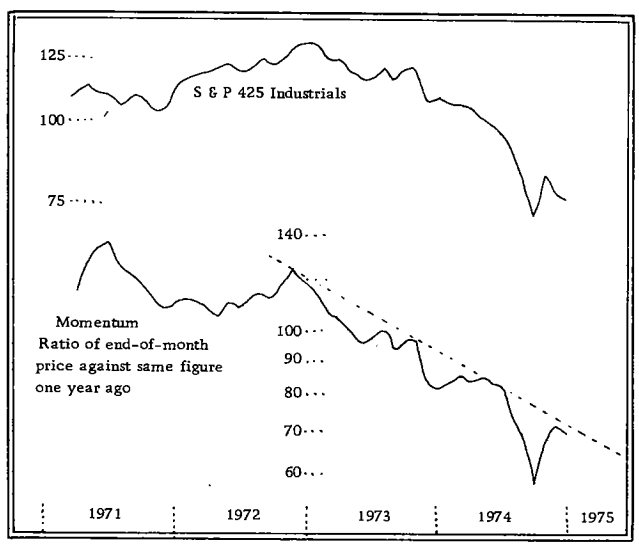
I do not feel it is necessary to wait for an actual crossing in the MA's before taking some action. I prefer to view a crossing as a confirmation of our general stance, but a very important confirmation it is. In recent Letters I have suggested that those subscribers who are ready to take trading or "pilot" positions do so, and I advocated this on the theory (based on many inferences) that the bear market may have ended in October, 1974.

If so, it will only be a matter of time before the 13-week MA pushes up and crosses above the 50-week MA. The two indicators have accelerated their closure rate, and they now appear to be moving together at a speed of about 7 to 10 points per week. At that rate (assuming it continues), a crossing could occur around April.

Remember, the 13-week MA and the 50-week MA were an extraordinary 133 points apart in December, the greatest such distance of the entire bear market. For this reason, we must consider the following: If we are in a primary bull market we will undoubtedly get a primary bull signal in the Averages before we can get a #1 or bull signal in the MA study.

This in no way robs the MA study of its usefulness. The position of the MA lines and the direction they are traveling is always an excellent guide to the investment position of the market. It is also well to remember that the greatest part of any move (past performance indicates this) comes after a crossing of the 13-week and 50-week MA's.

WATCH THE MOMENTUM: I show here a chart of the broad Standard & Poor's 425 stock average. I also show the ratio (end-of-month prices) of this Average against its price one year ago. This ratio shows the upside or downside momentum.



I have the record of the momentum in the 425 going back to the 1930's. It makes a fascinating history, and it is easy to see that well-defined trendlines in momentum, when they are reversed, signal turns in the Average. Since the 1930's there was only one instance in which a decline was so severe that it succeeded in taking the momentum ratio below 60. That was the 1937-38 bear market collapse which, in 1938, took the momentum to an incredible 48. I also have the momentum record of the Dow prior to that of the S & P 425, and of course in 1932 (amid the 1929-32 disaster) the Dow momentum sunk far below 60).

But the record of the 425 shows that since World War II no decline ever took the momentum ratio under 60 — until 1974. At last year's low, as we can see on the chart, the momentum dropped to a post-War nadir of 58. Interestingly, each wave of the bear market since 1966 has taken the 425 momentum to a lower level. In late 1966 the momentum dropped to 86. In mid-1970 the momentum smashed to 76. And then we had the extraordinary 58 reading of 1974.

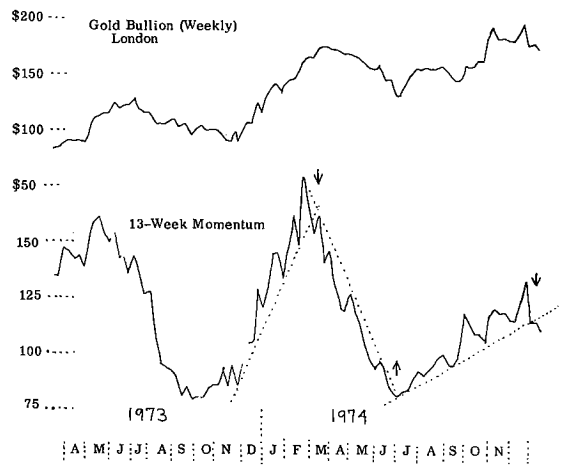
I have drawn a trendline connecting three peaks in the 425, peaks that were recorded in 1972, 1973, and 1974. It would require a momentum figure of 72 to reverse the trendline thereby turning the chart bullish. And here is the interesting part. A January, 1975 closing figure of 77.00 or better in the S & P 425 would produce a momentum figure above 72, thereby turning market momentum to the bull side. So the end of January closing price for the S & P 425 is one figure I'll be watching as this month passes into history.

GOLD: Some of my colleagues in the advisory business have a mistaken idea about my intentions. They seem to think I am in this business for the sole purpose of campaigning and proselytizing for gold and hard money. When, many months ago, I advised cutting back on gold holding I was chastised by my learned friends for being a traitor and for "deserting the cause." So let's get one thing straight. On a deep level, I believe in hard money and the thesis of "gold or fold." But I don't like to mix my fundamental philosophy of economics with my market studies. For the edification of all those who are reading these reports (and this includes all my well-meaning friends in the advisory field), when it comes to a question of what I believe is going to happen versus what the market tells me is going to happen — I always bow to my market studies.

I was recommending gold shares back in 1963, before most of today's gold-oriented advisories were in business. I was saying "cut back" on golds while most of today's gold-linked advisories were saying load up. Most recently I told subscribers to cut back to a position of no more than 25% gold items, 12% in gold coins and 12% in gold shares. That was the lowest level of gold participation that I have recommended in a decade. Why did I recommend such a small gold package in the face of what appears to be massive re-inflation during 1975 and 1976? Because my market studies appeared to be "giving me the word."

Letter 610 included a chart showing that the 34-week momentum line on the gold shares had turned decisively down. Because of that, I said that any potential explosion in the golds was going to be put off, it was not going to happen now. The market was simply telling its story. Next, in Letter 611 I introduced my gold bullion/gold share ratio chart, and I stated that the ongoing move was in favor of gold (coins), not the shares. In both of these Letters I stated that the market was telling us to be cautious, that something was amiss in the gold picture.

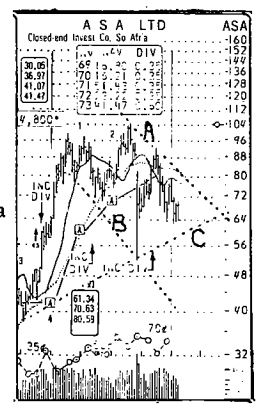
But underlying the whole gold panorama was the fact that gold bullion momentum was in a rising trend, having turned up in late-July, 1974. This was a technical plus for the gold structure. I included the gold momentum chart in Letter after Letter, and I gave the figures above which gold would have to hold if this chart was to remain bullish. Last week, as seen on the chart, the gold momentum turned down, and thus my warnings are coming to pass. On top of this, I published a chart in the last Letter showing that the three-year rising trend in the relative strength of the gold shares had reversed to the downside. The cracking relative strength means that gold shares will tend to act worse than the general market during both advances and declines.



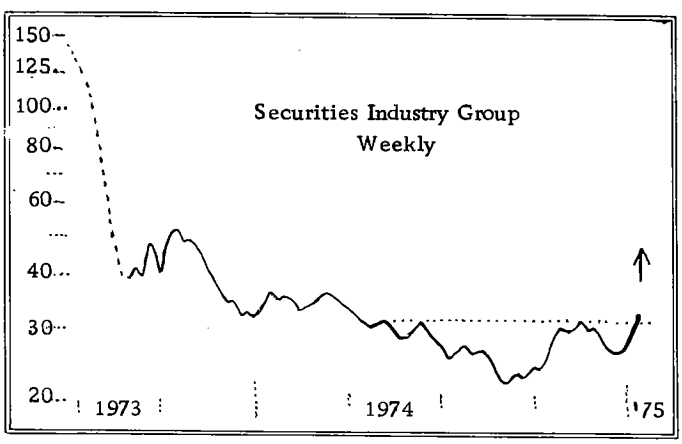
Does all this make Richard Russell a bear on gold? No, but it makes me a bear on gold timing. Gold can do two things, it can go up and it can go down. The market has told me that it is more likely to go down over the foreseeable future than up. If that is true, I would rather lighten up or step aside.

I have stated that I do not think we have yet seen the "big move" in gold. I feel it is coming as sure as the US dollar is ultimately going. But the timing, the timing, that's what I rack my brain over. The timing, I believe, is not now. When it arrives I certainly expect to get that information to subscribers. In the meantime, what is the use of being a hero and a stubborn one at that. I think the shares (and probably the bullion) are going lower. I want to be "traveling light" when that occurs for the simple reason that I don't know how low "low" is.

I note that already some answers to the gold puzzle are surfacing. The premium (the charge over the actual gold content) on the widely-circulated Krugerrand has now dropped from 17% to around 5% or less. The need for dollars is intense, the demand for gold (as inflation ebbs) is far less than expected. Supply and demand has taken over. On the mine front, S. African mining costs are rising at about 25% per year. In the face of this, if the gold price is pegged at say $200 or if gold stands still, the profits of the mines will be steadily squeezed. And that's the way the picture looks — now. Wild inflation, steady deflation, either could change the equation. But the deflationary effects of the current recession have provided a "stability" that does not help gold.



Technically, the bellwether gold stock, ASA, presents a fascinating picture at this time. The stock is in a rare "diamond formation" that is basically a variation of the "head-and-shoulder top," except that the base is extended into the diamond shape (see chart) via a sharp stab to the downside. ASA has been moving down the channel formed by the trendlines A and B. If the stock breaks trendline C (anything below 57), I would say that importantly lower prices would be in prospect. The stock is in the bearish position with price under the 10-week moving averages and the 10-wk MA below the 30-wk MA (chart courtesy of Quote, PO Box 213, Wichita KS 67201).



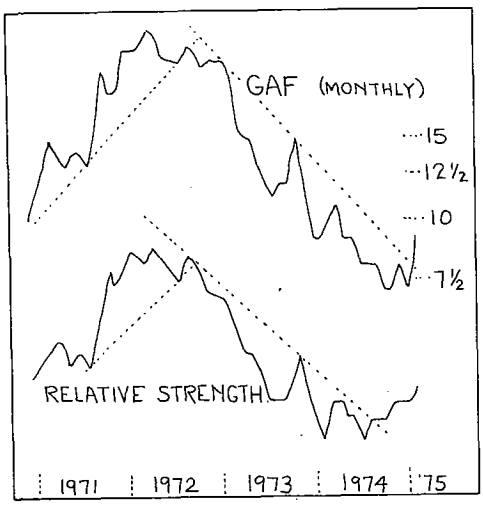
NOTES: On January 8, my 5-day moving average of daily new highs and new lows (NYSE) crossed over to the plus side. It has been on the plus side ever since with more daily new highs than lows. This is a happy occurrence for the market. The dearth of new lows also means that declines in the market are bringing corrections in stocks rather than costly breakdowns and new lows for the year.

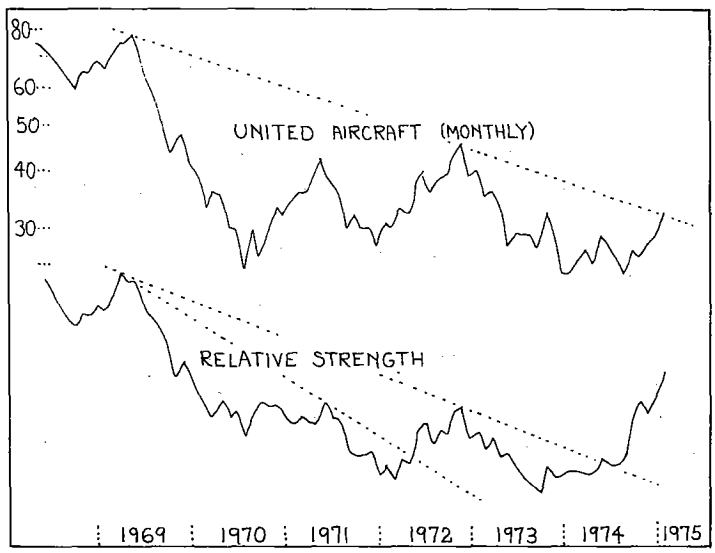
Here's a "happy chart" for my many subscribers in the securities business. It's also a bullish omen for Wall Street and the market in general. That beloved group, the brokerage houses, has formed a head-and-shoulders bottom, and last week it broke out to the bullish side. The group (Money Manager's unweighted average of all listed brokerage house stocks) rose to its highest level since April, 1974.

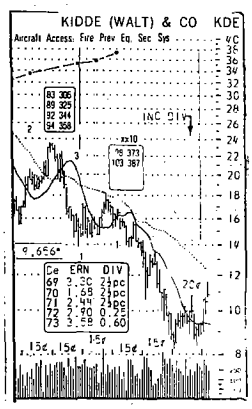
 Interestingly, the group hit bottom ahead of the market, on September 22, 1974. Actually, I am serious about this; I do take this as a bullish item for the market in general (after all, who prospers more in a bull market than Wall Street?).

The D-J 40-Bond Average struck an all-time low of 64.13 on October 3, 1974. It then rallied to 67.31 on November 18. For two months it backed and filled under the November recovery high. On January 21 the Bond Average made a new recovery high of 67.32. I consider this as constructive for the stock market.

The bellwether 91-day Treasury bills are now down to a 6.3% yield. Bank C/D's have dropped to 6.75% yields. The liquid (mutual) funds will have to bring their yields down now. This is going to present a problem to people with money coming due — what to do to get yields. I feel that the Savings & Loans are going to start attracting money soon, particularly since S & L accounts are insured up to $40,000. All this should be helpful to the economy in due time. The consensus now is — money rates coming down for a few months, then firming up as the Government comes in to raise cash for their big deficits. I never trust the consensus. If nothing else, the consensus is usually wrong on the timing of a move. With business loans dropping sharply, could the catch be that we will have "easy money" over the foreseeable future? Is that what the Utility Average has been telling as it moved well above its incredible 1974 low of 57.93?







STOCKS: It seems increasingly clear that many stocks have hit their bear market lows despite news of lower earnings, dividend cuts or other adversities that are bound to emerge. My chart of "all stocks on the NYSE in bullish trends" hit a late-1974 low of 14%. The January 15, 1975 figure (courtesy of Chartcraft, Larchmont NY) is 38.4%, with 56.7% of the Dow stocks now in bull trends. I have listed in past Letters stocks that can be accumulated. Of the Dow stocks I like Amer. Brands, Amer. Can, Johns-Manville (just turned up in relative strength after a 2½ year decline), and United Aircraft.

United Aircraft is showing great strength here, and I include a chart going back seven years. Here we see price and relative strength (or performance against the market) in uptrends. The price is about to reverse a major downtrend. I cannot overemphasize the importance of long-term relative strength reversals when buying stocks. A rising trend in RS means that the stock is acting better than the market (and this includes action during both declines and advances). UA is a stock worth accumulating in this area. RS trends can persist for many months and years.

GAF was recommended in the last Letter, and it had a big percentage move since then. The chart shows the reversals in both price and RS, and I think the stock is a buy on any weakness.

Add Kidde (small Quote chart) to stocks that I like and that are acting well in this area. The stock was in the high 70's in 1968, it has reversed a three-year decline in RS, it yields 6.9% at a price of 11½, and it is a value at today's price.

LATE NOTES: Written after the close, Wednesday, January 22. After trying for days to "get going" on the downside, the market gathered strength and ended on the plus side today. I keep a one-point reversal chart (point and figure style) on the Dow and the A-D ratio. The Dow graph moves up a box each time the Dow closes up any closing amount and down a box each time the Dow closes down any amount. I have a separate graph for the A-D ratio (all this thanks to Edson Gould, from whom I learned this method). If we get an "up day" in the Dow and on the A-D ratio on January 23, my two graphs will break out on the upside. The breakouts will come from the right shoulders of head-and-shoulders bottoms. This would be a powerful-looking move for the market.

In general, I think the market is basing. Many stocks are now forming bottoms, many others are breaking out. Very few are breaking down or hitting new lows. I'm still guessing we're in the early stages of a developing bull market.

Some of the recent stock selections are acting very well and can be purchased by those who have done nothing yet or added to by those who want to increase their position. Ogden acts very well, next target 19. National Distillers act beautifully. I like Transamerica here. General Foods (conservative) back in buy range as is Amer. Can, Amer. Brands. Melville Shoe acts well. Lucky Stores and Macy's can be bought in the retail group.